DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Extraordinary Dividend

This Field Service Advice responds to your memorandum dated April 22, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =

Assets =
Product X =

Sub =
Distributing =
Buyer =
Sub1 =
Buyer1 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Date 1 =

[redacted]

Date 2	=	
Date 3	=	
Date 4	=	
Date 5	=	
a	=	
b	=	
c	=	
d	=	
e	=	
f	=	
g	=	
h	=	
i	=	
j	=	
k	=	
l	=	
m	=	
n	=	
o	=	
p	=	
q	=	
r	=	

ISSUE:

Whether the dividend paid to Taxpayer by Distributing in the amount of $ o (or in conjunction with any other dividends that should be aggregated under § 1059(c)(3)) concurrent with a series of transactions is an "extraordinary dividend" within the meaning of § 1059, thus serving to reduce Taxpayer's adjusted basis in Distributing stock in an amount equal to the portion of the dividend excluded from gross income under § 243?

CONCLUSION:

The dividend paid to Taxpayer by Distributing in the amount of $ o (or in conjunction with any other dividends that should be agregated under § 1059(c)(3)) concurrent with a series of transactions is not an "extraordinary dividend" within the meaning of § 1059 because Taxpayer appears to have met the two year holding period under § 1059(a). Thus, Taxpayer's adjusted basis in Distributing stock is not reduced by an amount equal to the portion of the dividend excluded from gross income under § 243. In any event, Taxpayer may still make an election under § 1059(c)(4) (providing that Taxpayer can establish the fair market value of its Distributing stock to the satisfaction of the Secretary) to substitute the fair market value of the stock for the adjusted basis in determining the threshold percentage

[redacted]

under § 1059(c)(1) notwithstanding that Taxpayer did not comply with Rev. Proc. 87-33, 1987-2 C.B. 402.

FACTS:

From Year 1 to Date 1, Taxpayer owned and controlled certain Assets as one of its operating divisions. During that time and continuing to the present, the Assets manufactured Product X. On Date 1, Taxpayer incorporated the Assets as a wholly owned subsidiary, Sub.

On Date 2, Taxpayer sold a% of its stock in Sub to Buyer for $ b. On its Year 2 Form 1120, Taxpayer reported a gain on this transaction of $ c representing the difference between the amount realized and its adjusted basis of $ d. Taxpayer's reported basis in the stock was accepted at the time by the Service and is the starting point for all future basis calculations involving its Sub stock.

On Date 3, Taxpayer and Buyer formed Distributing, a domestic corporation, in a non-recognition transfer under § 351. At that time, Taxpayer and Buyer each contributed stock of various foreign subsidiaries and their respective stock interests in Sub in exchange for all of the stock of Distributing.[1] This arrangement permitted their foreign subsidiaries to become subsidiaries of Distributing, rather than its sister subsidiaries. The facts are unclear whether Sub subsequently merged into Distributing.

During Year 3 through Year 5, Distributing paid dividends to Taxpayer and Buyer totaling $ e in Year 3 ($ f each), $ g in Year 4 ($ h each), and $ i in Year 5 ($ j each).

On Date 4 (which occurs in Year 5), Distributing was recapitalized through the following series of transactions:

(1) Sub1, a wholly owned subsidiary of Distributing, borrowed $ k from a commercial lender.

(2) Sub1 issued $ l senior subordinated notes due in Year 6.

(3) Distributing repaid approximately $ m of its then existing debt.[2]

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[1] It appears that only common stock was issued in connection with this transaction.

[2] The facts are unclear how the money raised by Sub1 was transfered to Distributing.

[redacted]

(4) Distributing redeemed and canceled all of the common equity held by Buyer for $ n. As discussed below, following this redemption, Taxpayer became the 100% owner of Distributing.

(5) Distributing distributed $ o to Taxpayer as a purported dividend.

(6) Distributing then sold p newly issued shares of its common stock to Buyer1 for $ q. Following this sale, Buyer1 owned % r of Distributing.

Less than two years elapsed from the time Taxpayer acquired its stock in Distributing until it received the distribution in step (5), above, on Date 4.

On Date 5 (which occurs in Year 5), Taxpayer sold its remaining stock interest in Distributing. On its Year 5 Form 1120, Taxpayer reported the dividends received in Year 5 as normal cash dividends from a 20% or more owned corporation, resulting in an 80% dividend exclusion under § 243.[3]

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[3] For purposes of this FSA, Taxpayer's series of transactions will be respected, i.e., Taxpayer is, in fact, receiving a dividend at a time when Taxpayer is the only shareholder. Even though Taxpayer is the sole shareholder under its structure, at the time of the distribution, Taxpayer would still not qualify under § 243(c) for the 100% dividends received deduction because the dividend is still not a qualifying dividend as defined in § 243(b)(1). It is unclear whether Buyer1 actually purchased Distributing stock on Date 4 or at a later date. If Buyer1 actually purchased Distributing stock on Date 4, Taxpayer and Distributing were not members of the same affiliated group at the close of the day. If Buyer1 purchased the stock at a later date, then Taxpayer may be entitled to the larger dividends received deduction under § 243(a)(3) providing all the other requirements of that section are met. However, such dividends would not necessarily be qualifying dividends as defined by § 1059(e)(2) because the E&P was earned from a time Taxpayer and Distributing were not affiliated. Section 1059(e). See also § 243(b)(1).

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INTRODUCTION:

Section 1059 was added to the Code by § 53 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 565 (1984). Congress was concerned about certain tax motivated transactions where (1) a corporation acquired stock in another corporation (before the dividend declaration date) that would be eligible for the dividends received deduction under § 243 and would reduce the value of the stock after receipt of the dividend, (2) after receiving the dividend, the corporation would then sell the stock and claim the loss resulting from the decline in value of the stock as a short term capital loss, and (3) the short-term capital loss could offset short-term capital gain. Accordingly, Congress enacted § 1059 to prevent a corporation from receiving the loss described above by requiring it to reduce its basis in the stock of the distributing corporation stock by the non-taxed portion of the dividend. H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2 , at p. 1184-1187 (1984) and S. Prt. No.169, 98th Cong. 2d Sess.,vol. I at 170-175.

LAW:[4]

Section 243(a) provides "In the case of a corporation, there shall be allowed as a deduction an amount equal to the following percentages of the amount received as dividends . . . : (1) 70 percent, in the case of dividends other than dividends described in paragraph (2) or (3); . . . and (3) 100 percent, in the case of qualifying dividends (as defined in subsection (b)(1))."

Section 243(b)(1) provides: "For purposes of this section, the term 'qualifying dividend' means any dividend received by a corporation--(A) if at the close of the day on which such dividend is received, such corporation is a member of the same affiliated group as the corporation distributing such dividend . . . ."

Section 243(c)(1) provides: "In the case of any dividend received from a 20-percent owned corporation . . . subsection (a)(1) of this section, ... shall be applied by substituting '80 percent' for '70 percent.'"

Section 246 (c)(3) provides: "For purposes of this subsection, in determining the period for which the taxpayer has held any share of stock . . . (B) there shall not be taken into account any day which is more than 45 days . . . after the date on which such share becomes ex-dividend, and (C) paragraph (4) of section 1223 shall not apply."

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[4] All Code sections cited are the law as in effect for Year 5 unless otherwise indicated.

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Section 1059(a) provides: "If any corporation receives any extraordinary dividend with respect to any share of stock and such corporation has not held such stock for more than 2 years before the dividend announcement date--(1) . . . The basis of such corporation in such stock shall be reduced (but not below zero) by the nontaxed portion of such dividends. (2) . . . In addition to any gain recognized under this chapter, there shall be treated as gain from the sale or exchange of any stock for the taxable year in which the sale or disposition of such stock occurs an amount equal to the aggregate nontaxed portions of any extraordinary dividends with respect to such stock which did not reduce the basis of such stock by reason of the limitation on reducing basis below zero."

Section 1059(b) provides: "For purposes of this section--(1) . . The nontaxed portion of any dividend is the excess (if any) of--(A) the amount of such dividend, over (B) the taxable portion of such dividend. (2) . . . The taxable portion of any dividend is--(A) the portion of such dividend includible in gross income, reduced by (B) the amount of any deduction allowable with respect to such dividend under section 243, 244, or 245."

Section 1059 (c)(1) provides: "The term 'extraordinary dividend' means any dividend with respect to a share of stock if the amount of such dividend equals or exceeds the threshold percentage of the taxpayer's adjusted basis in such share of stock."

Section 1059(c)(2) provides: "The term 'threshold percentage' means "(A) 5 percent in the case of stock which is preferred as to dividends, and (B) 10 percent in the case of any other stock."

Section 1059(c)(3)(A) provides: "All dividends--(i) which are received by the taxpayer (or a person described in subparagraph (C)) with respect to any share of stock, and (ii) which have ex-dividend dates within the same period of 85 consecutive days, shall be treated as 1 dividend."

Section 1059(c)(3)(B) provides: "All dividends--(i) which are received by the taxpayer (or a person described in subparagraph (C)) with respect to any share of stock, and (ii) which have ex-dividend dates during the same period of 365 consecutive days, shall be treated as extraordinary dividends if the aggregate of such dividends exceeds 20 percent of the taxpayer's adjusted basis in such stock (determined without regard to this section)."

Section 1059(c)(3)(C) provides: "In the case of any stock, a person is described in this subparagraph if--(i) the basis of such stock in the hands of such person is determined in whole or in part by reference to the basis of such stock in the hands of the taxpayer, or (ii) the basis of such stock in the hands of the

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taxpayer is determined in whole or in part by reference to the basis of such stock in the hands of such person."

Section 1059(c)(4) provides: "If the taxpayer establishes to the satisfaction of the Secretary the fair market value of any share of stock as of the day before the ex-dividend date, the taxpayer may elect to apply paragraphs (1) and (3) by substituting such value for the taxpayer's adjusted basis."

Section 1059(d)(3) provides: "For purposes of determining the holding period of stock under subsection (a)(2), rules similar to the rules of paragraphs (3) and (4) of section 246(c) shall apply; except that "2 years" shall be substituted for the number of days specified in subparagraph (B) of section 246(c)(3)."

Section 1059(d)(6)(A) provides: "Subsection (a) shall not apply to any extraordinary dividend with respect to any share of stock of a corporation if--(i) such stock was held by the taxpayer during the entire period such corporation was in existence, and (ii) except as provided in regulations, no earnings and profits of such corporation were attributable to transfers of property from (or earnings and profits of) a corporation which is not a qualified corporation."

Section 1059(d)(6)(B) provides: "For purposes of subparagraph (A), the term 'qualified corporation' means any corporation (including a predecessor corporation)--(i) with respect to which the taxpayer holds directly or indirectly during the entire period of such corporation's existence at least the same ownership interest as the taxpayer holds in the corporation distributing the extraordinary dividend, and (ii) which has no earnings and profits--(I) which were earned by, or (II) which are attributable to gain on property which accrued during a period the corporation holding the property was, a corporation not described in clause (i)."

Section 1059(d)(6)(C) provides: "This paragraph shall not apply to any extraordinary dividend to the extent such application is inconsistent with the purposes of this section."

Section 1059(e)(2)(A) provides: "Except as provided in regulations, the term 'extraordinary dividend' does not include any qualifying dividend (within the meaning of section 243)."

Section 1059(e)(2)(B) provides: "Subparagraph (A) shall not apply to any portion of a dividend which is attributable to earnings and profits which--(i) were earned by a corporation during a period it was not a member of the affiliated group, or (ii) are attributable to gain on property which accrued during a period the corporation holding the property was not a member of the affiliated group."

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Section 1223(1) provides: "In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and, in the case of such exchanges after March 1, 1954, the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231. . ."

ANALYSIS:

Taxpayer could raise three possible arguments as to why the dividend or (dividends) paid to it by Distributing is not an "extraordinary dividend" within the meaning of § 1059. These arguments could focus on (1) whether Taxpayer can, pursuant to § 1059(c)(4), substitute the fair market value (FMV) of the stock for its adjusted basis in determining the threshold percentage under § 1059(c)(1), (2) whether Taxpayer has met the requirements of holding the stock of Distributing for Distributing's entire existence under § 1059(d)(6), and (3) whether Sub is a predecessor corporation of Distributing. We set forth our analysis of each of these items.

Substitution of FMV for adjusted basis

Taxpayer may argue that it can make an election under § 1059(c)(4) to substitute the FMV of the stock for the adjusted basis in determining the threshold percentage under § 1059(c)(1). As such, the dividend may not qualify as an "extraordinary dividend." Notwithstanding that Taxpayer has not complied with Rev. Proc. 87-33, 1987-2 C.B. 402, it may still be able to make the election under § 1059(c)(4) providing it can establish the FMV of the Distributing stock.

Compliance with Rev. Proc. 87-33

An "extraordinary dividend" is a dividend where the amount of such dividend equals or exceeds a certain threshold percentage of the taxpayer's adjusted basis in the stock of the distributing corporation. Section 1059(c)(1). When applying § 1059(c)(1), if "the taxpayer establishes the fair market value of any share of stock as of the day before the ex-dividend date," it may use that value in place of the adjusted basis. Section 1059(c)(4). No regulations have been issued establishing guidelines for making elections under § 1059(c)(4), nor does the legislative history provide any guidance. See, S. Rep. No. 313, 99th Cong., 2d Sess. at 250 (1986). However, procedures for electing to use the fair market value are set forth in Rev. Proc. 87-33.

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Sections 4 and 5 of Rev. Proc. 87-33 provide that in order to make an election under § 1059(c)(4), a taxpayer must request a written determination of the stock's FMV and attach a statement to the tax return for the year containing the ex-dividend date stating that it is making an election under § 1059(c)(4). The statement filed with the return must contain a number of specific items. Taxpayer did not comply with the revenue procedure, nor has it yet indicated that it wants to make the election under § 1059(c)(4).

Whether a taxpayer must comply with the Commissioner's exact procedures for making an election turns upon whether the regulatory requirements relate to the substance or essence of a statute or are procedural in nature.[5] American Air Filter Co. v. Commissioner, 81 T.C. 709, 719 (1983).

Determining whether Taxpayer must comply with Rev. Proc. 87-33 is determining whether the election process relates to the essence or substance of the statute or is procedural. To determine whether election mechanics relate to the essence of the statute "it is necessary to examine its purpose, its relationship with other provisions, the terms of the underlying statute, and the consequences of failure to comply with the provision in question." Valdes v. Commissioner, 60 T.C. 910, 913 (1973). Here, the purpose of the provision in question is to allow taxpayers owning appreciated stock to use the fair market value, rather than adjusted basis, when calculating an extraordinary dividend. It relates to no code provisions other than § 1059 and the terms of the statute provide no guidance as to what is necessary to claim the benefit of the election. The consequences of failure to elect is being required to use adjusted basis in determining whether there is an extraordinary dividend.

Examined in light of these factors, the election procedures under Rev. Proc. 87-33 do not relate to the essence or substance of the statute. Elections that relate to the essence of the statute are those that require the taxpayer to forgo some benefit or take some specific action in order to claim entitlement to a preferential Code provision. Thus, in Valdes the court held that because Valdes' imperfect election did not "reflect [his] unequivocal agreement to take the benefits and burdens of section 172(b)(1)(D)" he was not entitled to the extended carryback provisions under that Code provision. Valdes, 60 T.C. at 914-5. Similarly, in Penn-Dixie Steel Corp. v. Commissioner, 69 T.C. 837, 846-7 (1978), the court held that an election to rapidly amortize pollution control facilities was ineffective when the taxpayer failed to apply for certification of the facilities as required in the election. Here, unlike in Valdes and Penn-Dixie, there are no specific actions other than

[5] The election requirements in this case are not set by regulation. Nonetheless, cases addressing the regulatory framework for various elections provide the best guidance on this issue.

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getting an appraisal showing the fair market value of the stock that need to be taken to comply with election under § 1059(c)(4). Nor is there any benefit that Taxpayer needs to forgo to make the election. Therefore, the election under § 1059(c)(4) does not go to the essence of the statute.

When the requirements for making an election are procedural and the essential statutory purposes have been fulfilled, substantial compliance with the election provision is sufficient. American Air Filter, 81 T.C. at 719. Whether the taxpayer's compliance with election requirements is substantial depends upon several factors: whether the Commissioner has been prejudiced by the failure to literally comply with the election requirements, Sperapani v. Commissioner, 42 T.C. 308, 331-2 (1964); whether the statute or regulation provides specific instructions on how to make an election, Beaver v. Commissioner, 42 T.C. 72, 80 (1964), acq., 1965-2 C.B. 6; whether the sanction imposed upon the taxpayer for failure to make the election is out of proportion to the default, Columbia Iron & Metal Co. v. Commissioner, 61 T.C. 5, 10 (1973), acq., 1979-2 C.B. 2; and whether giving effect to the imperfect election would allow the taxpayer to gain the advantage of examining the issue in hindsight. Tipps v. Commissioner, 74 T.C. 458, 468-69 (1980), acq., 1982-2 C.B. 2. See American Air Filter, 81 T.C. at 719-20.

Here, Taxpayer has not only not complied with Rev. Proc. 87-33's rules for making an election - it has done nothing. But this failure to act must be considered in light of Taxpayer's likely argument that the disposition in question does not qualify as an extraordinary dividend. Thus, the issue here is slightly different than the usual ineffective election case. The question here is whether the election in these circumstances is required at all.

Examining substantial compliance in this case must begin with the standards set forth above. Here, the Commissioner is not necessarily prejudiced by Taxpayer's failure to make an election. If Taxpayer claims entitlement to the benefits of § 1059(c)(4), it must establish the FMV of the stock. Delaying this process may not necessarily prejudice the Commissioner. See Sperapani, 42 T.C. at 329-30 (noting that even had certain facts concerning an election been included in the election statement, the Commissioner would still have to verify those facts).

There is no specific language in the statute covering the election under § 1059(c)(4). The taxpayer need only "establish[] to the satisfaction of the Secretary the fair market of any share of stock." As in Beaver, the only requirement specifically in the statute is a general one. Beaver, 42 T.C. at 77-8. The penalty here for failure to elect, presumably inability to use the provisions of § 1059(c)(4), is, as in Columbia Iron & Steel, out of proportion to any harm caused to the Commissioner. Columbia Iron & Steel, 61 T.C. at 10.

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Lastly, in this case, Taxpayer, if it elects to use FMV, is not benefitting from the advantages of hindsight. See Valdes (finding that Congress required an election under § 172(b)(1)(D) to be unambiguous to ensure that a taxpayer did not take a wait-and-see attitude toward the election).

The election procedure set forth in Rev. Proc. 87-33 is clearly procedural. The contrary argument that an election under § 1059(c)(4) must be made in accordance with this procedure is apparently based upon administrative convenience. This argument was rejected in Sperapani and Tipps. Taxpayer's failure to make an election under Rev. Proc. 87-33 does not invalidate its claim to the benefits of § 1059(c)(4).

Timing of election

Even if Taxpayer does not need to use the election procedures set forth in Rev. Proc. 87-33, the issue of the proper time for claiming entitlement to § 1059(c)(4) is still important.

The time for making an election depends upon the nature and circumstances of the election. If the essential requirements of the underlying statute have been met and the information required for the election is provided to the Commissioner when requested, the specific election procedures need not be complied with. Columbia Iron & Metal Co., 61 T.C. at 9. In Columbia Iron & Metal, the taxpayer sought to deduct a charitable deduction, that was authorized but not paid, under § 170(a)(2). It did not attach the documents required under the applicable regulation to its tax return. The court found that the failure to include the required documents did not invalidate the deduction because the required information had since been given to the Commissioner.

In a case similar to this one, Dougherty v. Commissioner, 60 T.C. 917, 940 (1973), the court concluded that "[i]t is also significant to note that the instant case does not involve the kinds of difficulties inherent in other situations, where the granting of a right of a late election permits the taxpayer in effect to play both ends against the middle as the result of hindsight." There, at the time he filed his return, Dougherty was not aware that he would have foreign-sourced passive income for 1963. In 1968, when he discovered that he did have such income, he notified the Commissioner that he wanted such amounts taxed at corporate rates, as provided for in § 962. The Commissioner rejected the request because Dougherty failed to comply with the applicable election procedures.

The court concluded that consistent action by the taxpayer was the key factor in determining whether untimely elections were valid:

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> We distill from the decided cases that the critical question involved in determining the timeliness of a delayed election is whether 'the original action (or the failure to act) on the part of the taxpayer did not amount to an election against, and was not inconsistent with, the position which the taxpayer ultimately did adopt.'

Id. (citation omitted).

Doughterty did not take any actions in 1963 indicating that he did not seek the benefits of § 962; rather, until 1968 he believed that he had no foreign-sourced income. Thus, because it was "'sufficient for the taxpayer to indicate its election when it appears that a tax is due and when, therefore, an election first has significance,'" the court allowed the tardy election. Id. at 941 (citation omitted).

Here, Taxpayer has not taken any actions inconsistent with the provisions of § 1059(c)(4) and assuming that Taxpayer can provide information establishing the FMV of the Distributing stock to the Commissioner, it is entitled to use § 1059(c)(4).

Therefore, Taxpayer need not follow the election procedures set forth in Rev. Proc. 87-33 to claim the benefits of § 1059(c)(4). If Taxpayer can establish the FMV of the Distributing stock it may use that value for the purposes of § 1059.

Exception where stock held during entire existence of corporation

Taxpayer may argue that it has met the requirements of holding the stock of Distributing for Distributing's entire existence under § 1059(d)(6) and therefore, the distribution is not an "extraordinary dividend." Section 1059(d)(6) provides an exception to the 2 year holding period of § 1059(a) where the distributing corporation's stock was held by the taxpayer during the entire period such corporation was in existence if no earnings and profits of such corporation were attributable to transfers of property from (or earnings and profits of) a corporation which is not a qualified corporation.

Nevertheless, Taxpayer may not satisfy this exception if Distributing has earnings and profits of a corporation which is not a qualified corporation. Since there is conflicting information as to whether Sub merged into Distributing some time after the transactions occurring on Date 3, we have insufficient information, at this point, to determine whether Taxpayer actually qualifies under § 1059(d)(6).[6]

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[6] Also, we have insufficient information to determine whether there were transactions between Distributing and its subsidiaries other than Sub that would disqualify Distributing from the exception in § 1059(d)(6), i.e., Distributing may have received earnings and profits from one (or more) of such subsidiaries which may not be

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However, an analysis of this issue is set forth below based on whether Sub was or was not merged into Distributing.

Under § 1059(d)(6)(B) a qualified corporation "means any corporation (including a predecessor corporation)-- (i) with respect to which the taxpayer holds directly or indirectly during the entire period of such corporation's existence at least the same ownership interest as the taxpayer holds in the corporation distributing the extraordinary dividend, and (ii) which has no earnings and profits--(I) which were earned by, or (II) which are attributable to gain on property which accrued during a period the corporation holding the property was, a corporation not described in clause (i)." The legislative history further explains this provision as follows:

> The bill also clarifies the application of the special exception for dividends on stock that has been held during the entire existence of a corporation. This relief provision was intended to permit distributions without basis reduction, even though the distributions exceed the threshold percentage and are declared, announced or agreed to within the two-year holding period, only in those cases in which the earnings and profits of the corporation paying the dividend could not have been attributable, directly or indirectly, to any person other than the original shareholder receiving the distribution. For this purpose, earnings and profits are not considered attributable solely to such shareholder if any more than a de minimis part of such earnings and profits is derived, directly or indirectly, from any other entity in which the shareholder was not an original shareholder with an interest at least as great as such shareholder's original and continuing interest in the distributing corporation at the time of the distribution.
>
> Thus, for example, the relief provision does not apply if more than a de minimis part of the earnings and profits of the corporation paying the dividend were derived directly or indirectly from another corporation (e.g., <u>through a dividend distribution, a transaction described in sec. 381, a sale of assets received in a section 332 liquidation or other carryover basis transaction</u>, or . . .) in which the original shareholder did not at all times hold at least as great an interest as such shareholder's interest in the distributing corporation at the time of the distribution.

(Emphasis added). S. Rep. No. 445, 100th Cong., 2d Sess., at 42-43 (1988) at 42-43; H.R. Rep. No. 795, 100th Cong., 2d Sess., at 41 (1988); General Explanation of

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a qualified corporation.

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the Tax Reform Act of 1986, Staff of Joint Committee on Taxation, 100th Cong., 1st Sess., at 286 (1987).

If Sub merged into Distributing (or otherwise liquidated under § 332) after the transaction occurring on Date 3, § 1059(d)(6) does not apply because a portion of Distributing's earnings and profits are attributable to Sub. Section 381(c)(2). See also the legislative history quoted above. As of Date 2, Taxpayer only had only an a% interest in Sub. On Date 4, at the time the dividend was paid, Taxpayer had a 100% interest in Distributing. Therefore, Taxpayer did not hold directly or indirectly during the entire period of Sub's existence at least the same ownership interest Taxpayer holds in Distributing.

Furthermore, if there was no merger of Sub into Distributing or any other merger of a non-qualified corporation, § 1056(d)(6) would not apply if Distributing received a distribution from or otherwise had earnings and profits that were attributable to transfers of property from (or earnings and profits of) a corporation which is not a qualified corporation.[7]

Predecessor corporation

Taxpayer could argue that § 1059 does not apply in this case because it held the stock of Distributing for more than the 2 year period prescribed in § 1059(a) on the theory that Sub and Distributing (its successor in interest) should be treated as the same corporation for purposes of applying that section. Arguably, this approach is inconsistent with the express provisions of § 1059(a). Under § 1059(a), the basis of stock must be reduced if a corporation (i) receives a dividend with respect to any share of stock, and (ii) has not held the stock for more than two years. In the absence of Congressional intent to exempt from the reach of § 1059(a) distributions from successor corporations, successor corporations are not exempt from the reach of § 1059(a).

However, while § 1059(a) does not specifically exempt from the reach of § 1059(a) distributions from successor corporations, it does exempt some distributions from successor corporations indirectly through § 1059(d)(3). Section 1059(d)(3) specifically provides: "[f]or purposes of determining the holding period of stock under subsection (a)(2)[8], rules similar to the rules of paragraphs (3) and (4) of

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[7] As mentioned in footnote 2, above, the facts are unclear how the money raised by Sub1 was transferred to Distributing. It should be determined whether the money was transferred by way of a distribution.

[8] It could be argued that the holding period rules of § 1059(d)(3) do not apply here because the specific reference to § 1059(a)(2)(applying to recognition of gain

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section 246(c) shall apply; except that '2 years' shall be substituted for the number of days specified in subparagraph (B) of section 246(c)(3)." Section 246(c)(3) provides: "[f]or purposes of this subsection, in determining the period for which the taxpayer has held any share of stock . . . (C) paragraph (4) of section 1223 shall not apply." This suggests that paragraph (1) of § 1223 does apply. Section 1223(1), which generally provides that the holding period for exchanged basis property received in § 351 and § 368 transactions includes the period for which the taxpayer held the property exchanged, applies to all of subtitle A, including § 1059.[9]

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upon the disposition of stock in certain cases) does not literally refer to the operative 2 year holding period for the required reduction in basis. However, this reference appears to be a drafting glitch in the Code. Section 1059(d)(3) read substantially as specified above since the enactment of § 1059. However, at the time of enactment § 1059(a) read as follows: "If any corporation -- (1) receives an extraordinary dividend with respect to any share of stock, and (2) sells or otherwise disposes of such stock before such stock has been held for more than 1 year . . . ." Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 565 (1984). Section 1059(d)(3)'s reference to § 1059(a)(2) at that time made perfect sense by referring to the 1 year holding period requirement.

Section 614(a)(1) of the Tax Reform Act of 1986, Pub. L. 99-514 (1986) (the "Act") amended § 1059(a) to require that the dividend receiving corporation hold the stock of a distributing corporation more than 2 years before the dividend announcement date (rather than holding the stock for 1 year after receiving the dividend). The language in all of § 1059(a) was thus substantially changed. Section 614(a)(3) of the Act amended § 1059(d)(3) "by striking out '1 year' and inserting in lieu thereof '2 years.'" However, such amendment neglected to conform § 1059(d)(3)'s reference to § 1059(a)(2) which should refer to all of § 1059(a). Furthermore, § 1059(d)(3) is currently identical to § 614(a)(3) of the Act except that the reference to subsection (a)(2) has been changed to just subsection (a) by § 1604(d)(1) of the Taxpayer Relief Act of 1997, Pub. L. 105-34, 111 Stat. 1098 (1997) as a Technical Amendment. However, this particular amendment does not appear to have a retroactive date to the Act.

Since the technical correction, § 1059(d)(3) now harmonizes with § 1059(a). In any event, we think that it is appropriate to interpret the cross reference to (a)(2) (which does not mention any holding period) as a reference to the whole of paragraph (a).

[9] It appears Congress actually looked at certain holding period implications under § 1223 while enacting § 1059. H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2 , at p. 1184-1185 (1984) and S. Prt. No.169, 98th Cong. 2d Sess.,vol. I at 171.

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Therefore, it appears that Taxpayer may not be subject to § 1059 (or at least a large part of the distribution may not be subject to § 1059) because Taxpayer's holding period in all (or most all) of the Distributing stock appears to exceed the two year requirement under § 1059(a). Taxpayer received its Distributing stock on Date 3 in a § 351 transaction. Under § 358(a) Taxpayer receives an exchange basis in the stock of Distributing. That is, Taxpayer's basis in the stock of Distributing generally equals its basis in the assets Taxpayer contributed to Distributing in the § 351 transaction. Consequently, Taxpayer's holding period in such stock is determined under § 1223(1), provided the assets contributed in the § 351 transaction are capital assets. It appears that all the stock of the subsidiaries contributed to Distributing as part of the § 351 transaction were held by Taxpayer in excess of 2 years. Absent transfers of any other assets, Taxpayer would not be subject to § 1059(a) because it is deemed to have held the stock of Distributing in excess of two years pursuant to §§ 1059(d)(3), 246(c)(3) and 1223(1). Cf. § 1059(e)(1).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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If you have any further questions, please call (202) 622-7930.

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